Report No. DODIG-2013-063 April 8, 2013

Inspector General

United States Department of Defense

Award and Administration of Performance-Based Payments in DoD Contracts

Report Documentation Page					*Form Approved OMB No. 0704-0188*
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1. REPORT DATE **08 APR 2013**		2. REPORT TYPE			3. DATES COVERED **00-00-2013 to 00-00-2013**
4. TITLE AND SUBTITLE **Award and Administration of Performance-Based Payments in DoD Contracts**					5a. CONTRACT NUMBER
					5b. GRANT NUMBER
					5c. PROGRAM ELEMENT NUMBER
6. AUTHOR(S)					5d. PROJECT NUMBER
					5e. TASK NUMBER
					5f. WORK UNIT NUMBER
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) **Department of Defense Office of Inspector General,4800 Mark Center Drive,Alexandria,VA,22350**					8. PERFORMING ORGANIZATION REPORT NUMBER
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)					10. SPONSOR/MONITOR'S ACRONYM(S)
					11. SPONSOR/MONITOR'S REPORT NUMBER(S)
12. DISTRIBUTION/AVAILABILITY STATEMENT **Approved for public release; distribution unlimited**					
13. SUPPLEMENTARY NOTES					
14. ABSTRACT					
15. SUBJECT TERMS					
16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT	18. NUMBER OF PAGES	19a. NAME OF RESPONSIBLE PERSON
a. REPORT **unclassified**	b. ABSTRACT **unclassified**	c. THIS PAGE **unclassified**	**Same as Report (SAR)**	**51**	

Standard Form 298 (Rev. 8-98)
Prescribed by ANSI Std Z39-18

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Acronyms and Abbreviations

ACO	Administrative Contracting Officer
DCMA	Defense Contract Management Agency
DFAS	Defense Finance and Accounting Service
FAR	Federal Acquisition Regulation
PBP	Performance-Based Payment
PCO	Procurement Contracting Officer

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April 8, 2013

MEMORANDUM FOR DIRECTOR, DEFENSE PRICING

SUBJECT: Award and Administration of Performance-Based Payments in DoD Contracts (Report No. DODIG-2013-063)

We are providing this report for information and use. DoD contracting personnel needed additional guidance and training to better award and administer the $13.2 billion in performance-based payment events contained in the 60 contracts reviewed. These improvements should reduce DoD's risk of making future payments without measurable contractor performance and help ensure the contractor obtains full performance before payment.

We considered Defense Pricing comments on a draft of this report when preparing the final report. The comments conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 601-5945.

Lorin T. Venable

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Acting Assistant Inspector General
DoD Payments and Accounting Operations

Results in Brief: Award and Administration of Performance-Based Payments in DoD Contracts

What We Did

We determined whether DoD contracting personnel's negotiation and administration of 60 performance-based payment schedules, which identify all events for a contract, were in compliance with Federal Acquisition Regulation and DoD requirements. Specifically, we determined whether DoD properly negotiated, verified, and disbursed the payment requests. The contracts containing the schedules were awarded from FY 2009 through FY 2011 and are valued at $13.2 billion.

What We Found

Contracting personnel did not properly evaluate and negotiate schedules. Specifically, they did not:

- establish appropriate events for 1,807 events out of 2,356 total events on 57 approved performance-based payment schedules, and determine whether the event value fairly represented contract performance for 44 schedules;
- clearly define the criteria for successful completion in 33 schedules, identify events as severable or cumulative in 23 schedules, and specify completion dates in 21 schedules; or
- properly negotiate and verify the contractors' need for contract financing or level of investment before authorizing performance-based payments in all 60 sample contracts.

This occurred because DoD contracting personnel did not perform adequate reviews of schedules provided by contractors and did not use expenditure data or other independent data to value events. In addition, DoD guidance did not require contracting personnel to take any performance-based payment contract financing training and DoD guidance was inadequate and inaccurate.

As a result, DoD risked making advance payments totaling $11.4 billion and might have made full payments for less than full contract performance. Also, the Government could have needlessly incurred $28.8 million in carrying costs associated with the $7.5 billion that DoD paid contractors. The Government could realize potential monetary benefits of $13.6 million to $53.3 million over the next 5 years related to reduced carrying costs. Finally, DoD limited its ability to ensure that it received adequate consideration.

What We Recommend

The Director, Defense Pricing, should:

- require that contracting personnel request a contractor estimate of expenditures before approving the performance-based payment schedule;
- develop a training program that includes a discussion on appropriate event descriptions and required elements; and
- update guidance to require contracting personnel to determine whether the contractor could obtain private financing and the amount of contract financing and define what a reasonable level of contractor investment is.

Management Comments and Our Response

Management comments were responsive, and no additional comments are required. Defense Pricing will issue guidance addressing the topics contained in the recommendations. Please see the Recommendations Table on the back of this page.

Recommendations Table

Management	Recommendations Requiring Comment	No Additional Comments Required
Director, Defense Pricing		A.1.a, A.1.b, A.1.c, A.1.d, A.2 B.1.a, B.1.b, B.1.c, B.2.a, B.2.b C.1, C.2, C.3

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Introduction

Objective

Our objective was to determine whether DoD contracting personnel negotiated and administered performance-based payment (PBP) schedules in DoD contracts in accordance with selected Federal Acquisition Regulation (FAR) requirements. Specifically, we determined whether DoD properly negotiated, verified, and disbursed PBPs. See Appendix A for a discussion of our scope and methodology.

Background

The Government can provide contract financing for contractors before it accepts the supplies or services. FAR Part 32, "Contract Financing," prescribes the policies and procedures for providing contract financing payments and provides the rationale for contract financing. Specifically, FAR 32.104, "Providing Contract Financing," states that prudent contract financing can expedite the performance of essential contracts. It further states that the contracting officer must:

- provide Government financing only to the extent actually needed for prompt and efficient performance;
- administer the contract to aid the acquisition and avoid an undue risk of monetary loss to the Government;
- monitor the contractor's use of the contract financing provided and financial status; and
- include in the solicitation the form of contract financing that is in the Government's best interest.

FAR Subpart 32.10, "Performance-Based Payments," prescribes PBP policies and procedures. FAR 32.1001, "Policy," states that PBPs are the preferred type of contract financing when the contracting officer finds them practical and the contractor agrees to their use.

Requirements for Contract Financing

If the contracting officer determined that the contractor is eligible for PBPs, FAR 32.1004, "Procedures," requires the contracting officer to establish the basis for performance on specifically described events or a measurable criterion of performance. It also requires contracting officers to include within the contract a description of what constitutes successful performance of the event and whether the event is severable from or cumulative with other events.[1]

[1] A severable event is independent of any other event; a cumulative event depends on the successful completion of another event.

Furthermore, FAR 32.1004 requires that the total of all PBPs not exceed 90 percent of either the contract price or the delivery item price, depending on whether the PBP basis is the whole contract or a delivery item. It also requires that each payment be commensurate with the value of the event. Further, the contractor would not have an unreasonably low or negative level of investment in the contract. This would occur if the contractors received more PBPs than incurred expenses (including overhead and profit), which would provide them with a positive cash flow and no financial risk.

DoD Roles and Responsibilities

The Deputy Under Secretary for Acquisition Reform issued the "User's Guide to Performance-Based Payments," Revision 1, November 30, 2001 (2001 guidance), which provides specific DoD guidance for PBPs. In 2012, the Director, Defense Procurement and Acquisition Policy, responsible for all DoD acquisition and procurement policy matters, issued draft guidance titled, "Performance Based Payments Guide: The Better Buying Power Initiative" (2012 draft guidance). This guidance states that it was designed to provide assistance to users based on 15 years of PBP contracting lessons learned.

The Director of Defense Pricing is supported by the Defense Procurement and Acquisition Policy office and reports to the Under Secretary of Defense (Acquisition, Technology and Logistics). One responsibility of the Director of Defense Pricing is to establish DoD financing policies. Accordingly, the Defense Pricing's website states that the 2012 draft guidance (issued by Defense Procurement and Acquisition Policy) will become final after a proposed change to the Defense Federal Acquisition Regulation Supplement becomes final.

The procurement contracting officer (PCO) is responsible for negotiating the PBP terms with the contractor. The Defense Contract Audit Agency can provide assistance in establishing and valuing PBP events when requested. Once the PCO and contractor negotiate the PBP terms, the PCO includes the PBP schedule as part of the contract. The PCO may delegate administrative responsibilities, such as PBP event verification, to the administrative contracting officer (ACO), who is generally an employee of the Defense Contract Management Agency (DCMA). During contract performance, the ACO verifies successful completion of an event, and requests payment from the Defense Finance and Accounting Service (DFAS) Columbus.

Universe and Nonstatistical Sample

DFAS Columbus Mechanization of Contract Administration Services records contained 770 open PBP contracts awarded from FY 2009 through FY 2011, with $27.9 billion in PBP disbursements through May 16, 2012. We nonstatistically selected 60 contracts to determine whether DoD properly negotiated, verified, and disbursed PBPs. We included Army, Navy, and Air Force sites based on PBP disbursement amounts. The 60 contracts included $13.2 billion in PBP events, with one PBP schedule per contract. A PBP schedule includes all the PBP events for the contract. There were a total of 2,356 PBP events on those schedules. Furthermore, the 60 contracts included 682 PBP disbursements totaling $7.5 billion. DoD had not disbursed the remaining $5.7 billion of PBP events on the 60 contracts as of May 16, 2012. See Appendix A for details on the

sample selection. DoD purchased a variety of items on the sampled contracts, including missiles and test flight equipment. We conducted site visits to discuss the sampled contracts with contracting personnel at TACOM in Michigan, U.S. Army Redstone Arsenal in Alabama, U.S. Army Aberdeen Proving Ground in Maryland, U.S. Army Program Executive Office for Simulation, Training, and Instrumentation in Florida, Naval Air Station Patuxent River in Maryland, Naval Air Warfare Center in Florida, Eglin Air Force Base in Florida, and Hill Air Force Base in Utah. See Appendix B for a list of the sample contracts.

DoD Costs to Provide Contract Financing

FAR 32.1004 states that contract financing costs the Government in terms of interest paid by the Treasury to borrow funds to provide financing to the contractor. From January 1, 2010, through December 31, 2012, the U.S. Treasury set the interest rate at 1 percent. Historically the rate fluctuated, rising as high as 18 percent.

Review of Internal Controls

We determined that internal control weaknesses in the award and negotiation of PBPs existed as defined by DoD Instruction 5010.40, "Managers' Internal Control Program (MICP) Procedures," July 29, 2010. Specifically, DoD did not have adequate guidance and training to ensure compliance with FAR and DoD requirements to negotiate and verify PBP requests. We will provide a copy of the report to the senior official responsible for internal controls in Defense Pricing.

Finding A. Evaluation and Negotiation of Event Schedules Needed Improvement

DoD contracting personnel[2] did not properly evaluate and negotiate PBP schedules. Specifically, for the 60 PBP schedules reviewed, they did not:

- establish appropriate events for 1,807 out of 2,356 events on 57 approved PBP schedules. This occurred because DoD guidance was inadequate and DoD contracting personnel needed specific PBP training. Therefore, DoD contracting personnel either misunderstood or were not aware of the FAR requirements for defining the performance events that allowed payment to the contractor. In the absence of thorough DoD policy and adequate training, contracting personnel did not scrutinize the contracts but accepted contractor-provided PBP schedules.

- determine whether the event value fairly represented contract performance for PBP events on 44 schedules. This occurred because DoD contracting personnel generally did not use either contractor-provided cost expenditure data or other independent confirmation when they valued the PBP amounts. Instead, DoD contracting personnel generally relied on the contractor to establish the value of the PBP events.

As a result, DoD contracting personnel put DoD at risk of making advance payments totaling $11.4 billion for 57 of the 60 contracts reviewed. Also, they did not receive contract performance commensurate with the value of the payments that DoD made. In these instances, DoD provided a more favorable level of financing than required by the FAR. DoD could reduce financial risk by evaluating and renegotiating current PBP schedules when the schedule values do not accurately represent the cost of the events.

Evaluating and Negotiating Event Schedules

DoD contracting personnel included numerous inappropriate performance events in their evaluation and negotiation of PBP schedules. These errors resulted from inadequate guidance and training, as well as overreliance on contractor-provided PBP schedules.

Contracting Personnel Included Inappropriate Performance Events

DoD contracting personnel included 1,807 inappropriate events out of 2,356 total events reviewed in 57 of the 60 PBP schedules. Specifically, contracting personnel included events for purchase orders, passage of time, Government acceptance, kickoff meetings, postaward conferences, and starting tasks. However, FAR Subpart 32.10 states that these are inappropriate performance events.

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[2] Contracting personnel could include the PCO, a contract specialist, or other qualified contracting officials.

Instead, FAR Subpart 32.10 states that PBP events must represent meaningful efforts or actions and must be an integral and necessary part of contract performance. In addition, the FAR states that the basis for an event should be either specifically described events or a measurable criterion of performance. For example, contract N61340-11-C-0006 identified well-negotiated events that represented meaningful efforts that were integral and necessary for contract performance. That is, for the majority of tactical flight trainer events, the contracting officer linked the PBP event schedule to particular engineering events required during contract performance. For example, the events were for a preliminary design review, critical design review, and various stages of completion.

Table 1 lists the type of inappropriate events, how often the inappropriate events occurred, and dollar amounts associated with the events.

Table 1. Inappropriate Events

Inappropriate Event	Number of		Amount (in millions)
	Schedules	Events	
Purchase order	44	274	$644.9
Monthly payment/passage of time	18	1,415	10,852.0
Government acceptance	9	67	18.0
Kickoff meeting/postaward conference/“entry” event	27	216	419.7
Total	**57**(1)	**1,807**(2)	**$11,389.9**(2)

[1]Does not add up because some schedules contained multiple inappropriate events.
[2]Does not add up because some events contained multiple issues.

Purchase Orders Are Not Appropriate Events

DoD contracting personnel inappropriately established 44 PBP schedules that included the placement of purchase orders for 274 PBP events valued at $644.9 million. For example, contract W56HZV-09-C-0311 contained a PBP schedule that included 14 PBP events totaling $27.3 million for the placement of material purchase orders for mine resistant ambush protected vehicles. These events totaled 43.6 percent of the total contract value. See Appendix C for additional PBP schedules that included the placement of purchase orders as an event.

FAR 32.1004 explicitly prohibits the signing of contracts or modifications as PBP events because these events do not represent any meaningful efforts or actions. The placement of purchase orders constituted the signing of contracts with subcontractors and, therefore the FAR considered the events inappropriate.

DoD contracting personnel stated that they were unaware that the FAR prohibited the placement of purchase orders as a payment event. The contracting personnel generally stated that they included the event because the contractor provided funding to the vendors when they placed the purchase orders. However, they did not have documentation to support that the contractor provided funding when they placed the purchase order.

If the contractor provided funding to the subcontractor before work was performed, this could be considered an advance payment. DoD is not permitted to make advance payments unless specifically authorized by statute. In addition, some contracting personnel stated that they included the purchase orders as an event because the contractor performed some work when placing the purchase orders, and they wanted to compensate the contractor for the incurred costs.

If the contractor provided funding to the subcontractor before work was performed, this could be considered an advance payment.

Monthly Payments or Passage of Time Are Not Appropriate Events

DoD contracting personnel inappropriately established 1,415 PBP events for monthly payments or passages of time for 18 contracts valued at $10.9 billion. For example, contract W58RG7-09-C-0147 contained 42 PBP events, valued at $187.6 million, for recurring or sustaining efforts required to support the overall new build for the Apache Block III helicopter for Taiwan. Contracting personnel based the successful completion of these events on the completion of 1 month's effort, and the PBP schedule ensured that the contractor would receive monthly payments from October 2009 through June 2012.

FAR 32.1004 explicitly prohibits payments based on the passage of time because these events do not represent meaningful efforts or actions. Contracting personnel stated that they provided contract financing monthly because the contractors incurred costs during that time. (See Figure C-1 in Appendix C for this example.) However, a payment policy that provides contract financing solely on the basis of costs without consideration as to meaningful events is more in line with progress payment financing, which reimburses contractors' costs regardless of successful performance.

Government Acceptance of Goods or Services Is Not an Appropriate Event

DoD contracting personnel inappropriately established Government acceptance of goods or services as PBP events for nine contracts valued at $18.0 million. In sample contract W56HZV-09-C-0311, contracting personnel improperly established a schedule that included 23 PBP events, totaling $9.6 million, for delivery and Government acceptance of bar armor kits for the mine resistant ambush protected vehicles. DFAS disbursed $5.0 million related to 12 of the 23 events because the ACO approved that the contractor successfully completed the events. DFAS did not pay the remaining 11 events because the newly assigned ACO recognized that contracting personnel should not have included acceptance as an event and did not approve these PBP events. (See Figure C-2 in Appendix C for additional examples of Government acceptance.)

FAR 32.1001, "Policy," states that PBPs are not payment for accepted items. The DCMA Instruction for PBPs, section 1.2.1, provides additional guidance and states that the ACO should not use the Government acceptance of goods and services as an event or criterion for PBPs. Therefore, contracting personnel should not include the acceptance of contracted goods and services as PBP events.

Kickoff Meetings, Postaward Conferences, and Entry Events Are Not Appropriate Events

DoD contracting personnel inappropriately included 216 kickoff meetings, postaward conferences, and "entry" events[3] as PBP events for 27 contracts totaling $419.7 million. According to DoD contracting personnel, they used kickoff meetings or postaward conferences to discuss the logistics of executing the contract and to ensure contractor performance. In sample contract FA8675-10-C-0014, for the purchase of air-to-air missiles, contracting personnel included 11 events for a postaward review totaling $137.8 million, or 29.2 percent of the total PBP value. Contracting personnel approved these 11 events because each postaward review related to a different subcontractor. In addition, contract W56HZV-09-C-B014 for Marauder vehicles included five events, valued at $673,249, for starting the assembly of the vehicles. (See Figures C-2 and C-3 in Appendix C for examples of PBP schedules that use "entry" as a PBP event.)

The FAR does not explicitly prohibit the use of kickoff meetings, postaward conferences, or "entry" event as PBP events. However, these events do not meet the FAR 32.1004 requirement that the events represent meaningful efforts or actions and be integral to contract performance. To meet the FAR criteria, the entry should include definite entrance criteria that require successful completion of other events or tasks necessary to begin the event process. Without this description, this type of event would not represent meaningful work.

DoD contracting personnel stated that they included these types of events because the contractor had incurred costs before the meetings, including proposal and negotiation costs as well as costs to actually start the event. Therefore, they structured the PBP event to provide financing soon after the contract award. However, this approach was more in line with progress payments, which provide financing based solely on contractor costs, not PBPs.

Inadequate Guidance and Training Resulted in Overreliance on Contractor-Provided Data

Because of the inadequate guidance and training related to defining events, the contracting personnel did not properly review the contractor's proposal and often relied on the contractor to provide the PBP schedules. Specifically, of the 60 sample contracts, the contractor initially proposed the PBP schedule for 50 contracts. Contracting personnel often accepted the initial proposals with little to no investigation or revision. DoD needs to improve guidance on appropriate PBP events and require DoD contracting personnel to take PBP training.

DoD Guidance on Appropriate Events Needed Improvement

DoD guidance was not adequate for contracting personnel to negotiate only appropriate PBP events. Specifically, the guidance was inadequate because it did not prohibit the placement of purchase orders as PBP events. Although the 2001 guidance states that

[3] An "entry" event is the start of a task—for example, starting training or starting production.

events such as "signing the contract" or "exercising an option" were not appropriate PBP events, it did not specifically state that signing purchase orders was similar to signing a contract and therefore not appropriate. In addition, the 2012 draft guidance states that ordering of parts is not generally a good PBP event. It also states that contracting personnel may use purchase orders as an early PBP event "if there are no more meaningful events in that time period." However, this guidance conflicts with the FAR criteria that the signing of contracts is not an appropriate event.

DoD guidance also needed improvement to ensure that contracting personnel did not include kickoff meetings, postaward conferences, and entry events as PBP events. Specifically, the 2001 guidance and 2012 draft guidance do not specifically state that kickoff meetings, postaward conferences, and entry events are not appropriate. The 2012 draft guidance states that structuring an event to be the start of an effort falls short of FAR requirements and may not represent meaningful work; however, contracting personnel need additional, detailed guidance. The guidance also fails to highlight that the purpose of PBP financing is not to provide funding solely because the contractor incurred costs. Rather, it should be tied to specific, measurable, appropriate events. As discussed above, this is an important distinction because several contracting officers were structuring their PBP events to provide contractors compensation for their incurred costs.

Therefore, the Director, Defense Pricing, should ensure that guidance states that contracting personnel only include meaningful events and prohibits purchase orders, passage of time, Government acceptance, kickoff meetings, postaward conferences, and entry events as PBP events. In addition, the guidance should state that the purpose of PBP financing is not to provide funding solely because contractors incurred costs. Rather, it should be tied to specific, measurable, appropriate events.

Improved Training on PBP Events

The contracting personnel were unaware of the criteria for establishing PBP events. For example, they were unaware that the FAR prohibits purchase orders as events and some of them stated they included Government acceptance as events because they were not aware of the FAR requirements. The lack of awareness of FAR criteria was in part because 63 of the 87 contracting personnel interviewed had not taken any PBP-specific training. Therefore, the Director, Defense Pricing, should require that contracting personnel involved in establishing PBP schedules take training that includes a discussion on purchase orders, passage of time, Government acceptance of goods or services, kickoff meetings, and postward conference and entry events, which are not appropriate criteria or events. In addition, the training should emphasize that the purpose of PBP financing is not to provide funding solely because the contractor incurred costs. Rather, it should be tied to specific, measurable, appropriate events.

Performance-Based Amounts Were Not Commensurate With Event Values

DoD contracting personnel did not verify that PBP amounts were commensurate with the value of the defined event for 44 of 60 PBP schedules, as required by the FAR. DoD contracting personnel could have obtained an expenditure profile or other independent

assessment to determine whether the PBP amounts were commensurate with the event value. An expenditure profile is one way to provide the DoD contracting personnel insight into the contractor's actual costs and assist in the negotiation of the PBP event amounts. However, for 42 contracts, contracting personnel did not request an expenditure profile or other independent assessment of PBP values.

Contract W56HZV-09-C-B014 for Marauder vehicles provided an example of events that likely were not commensurate with the work performed. Specifically, DoD contracting personnel established an event for the start of vehicle assembly, valued at 12 percent of the contract price, with no rationale to support the value of the event. This event was not likely commensurate with the PBP amount because DoD contracting personnel paid the contractor for starting assembly rather than when assembly was complete. An expenditure profile could have assisted DoD contracting personnel in determining whether the value of this event was commensurate with the PBP amount. See Figure C-3 in Appendix C for an additional example of a PBP event and amount that is not representative of its value.

Relying on the contractor's independent estimate with no additional analysis can be inherently risky. Although contracting personnel obtained and used the contractor's expenditure profile during PBP negotiations for contract W31P4Q-11-C-0001, they did not perform any analysis of the expenditure profile. For this contract, the contractor's actual incurred cost data were usually 20 percent lower than the contractor's estimated expenditure profile. For example, the contractor had cumulative costs and profit of $325.3 million for January 2012; however, according to the contractor's estimated expenditure profile, the incurred costs plus profit for January 2012 was $271.0 million. Therefore, the PBP values defined in the beginning of the contract did not match the actual cost of work performed.

> *Although contracting personnel obtained and used the contractor's expenditure profile during PBP negotiations, they did not perform any analysis of the expenditure profile.*

The FAR requires that PBPs be commensurate with the value of the contractor performance. Specifically, FAR 32.1004 states that the contracting officer is to ensure that PBP amounts are commensurate with the value of the performance event or performance criterion, and the contracting officer may request expenditure profile information. The FAR further states that the contracting officer may establish performance-based amounts on any rational basis, including but not limited to engineering estimates of stages of completion, engineering estimates of hours expended to complete the event, or the estimated projected costs of performance of particular events.

Enhanced Guidance for Determining Performance-Based Amounts

DoD contracting personnel did not obtain accurate data to validate that the PBP was commensurate with the value of the defined event for 44 of 60 schedules because the DoD guidance was inadequate. Specifically, the 2001 guidance states that contracting

officers should establish event values that are commensurate with the approximate value of the progress. In addition, contracting officers were not to structure the event values as advance payments. However, the guidance did not provide any instructions on how the contracting officer could accomplish those goals.

The 2001 guidance states that the growing reliance on price-based acquisition techniques could result in the Government not knowing when the contractor would incur costs during the contract. Therefore, the parties had to arrive at PBP values that represented a businesslike approximation of the contractor's financing needs. This guidance needed clarification because it did not provide any specific steps that the contracting officer could follow. In addition, the 2001 guidance is silent on assigning PBP amounts based on engineering estimates, which the FAR allows.

The 2012 draft guidance requires that the contracting officers obtain a copy of the contractor's expenditure profile. The guidance also requires the contracting officers to provide an analysis of whether the expenditure profile is reasonable. This is an improvement upon the 2001 guidance. However, the 2012 draft guidance does not include the other ways the FAR states to assess the event value, such as use of engineering estimates and other independent estimates of event value. The Director, Defense Pricing, should issue guidance that includes a discussion of what DoD contracting personnel should request, whether an expenditure profile or other independent data, to verify that PBP amounts are commensurate with the value of the events. Further, if contracting personnel request an expenditure profile, the guidance should state that the contracting personnel need to review its accuracy.

Contracting Personnel Need to Improve the Method of Evaluating and Negotiating Schedules

DoD contracting official actions put the Government at risk of making advance payments, totaling $11.4 billion, for 57 of the 60 contracts reviewed, and DoD did not receive a commensurate amount of contract performance for the payments made to the contractor. In these instances, DoD provided a more favorable level of financing than authorized by the FAR. DoD could reduce its risk by evaluating and renegotiating current PBP schedules if they do not accurately represent the cost of events.

When DoD awarded PBPs for more than the value of the work performed, DoD unnecessarily increased its financial risk. The FAR provides that DoD take title to all contractor work-in-progress when they make PBPs, which mitigates DoD's financial risk. However, when contracting personnel negotiated the PBPs for more than their value or established an event for which the contractor had not completed work, they might have inadvertently set up an advance payment. According to the FAR, advance payments are the least favorable type of contract financing and, if used, the contracting officer would need to obtain adequate financial security from the contractor. Therefore, when contracting personnel structured the PBP events so that the payment amounts were more than the work performed, DoD would not obtain additional security for the financing provided in excess of the contractor's work, and DoD would not have title to the work the contractor had not started.

FAR 32.1001 states that PBPs are fully recoverable in the event of default, and the Government has title to all work-in-progress. However, if the event value was not commensurate with the work-in-progress, the Government would be unable to take possession of anything commensurate with these payments because the contractor would not have performed sufficient work. For example, in contract W56HZV-09-C-0311, which included 14 PBP events totaling $27.3 million for the placement of material purchase orders, the contractor did not have possession of the material. Therefore, there was a financial risk to the Government if it paid for material that was not controlled by the contractor.

The Director, Defense Pricing, should direct DoD contracting personnel to review all open PBP contracts to verify that the PBP amounts fairly represent the event values. If the PBP amounts are significantly higher than the contractor's costs or engineering estimates, contracting personnel should consult their legal advisors to consider available corrective actions, including renegotiating the PBP values to ensure that they are not providing advance payments.

Recommendations, Management Comments, and Our Response

A. We recommend that the Director, Defense Pricing:

1. Issue guidance that:

a. Includes only the use of meaningful events and prohibits the use of purchase orders, the passage of time, acceptance of end items, kickoff meetings, postaward conferences, and entry events as acceptable performance events.

b. States that the purpose of performance-based payment financing is not to provide funding solely because the contractor incurred costs. Rather, it should be tied to specific, measurable, appropriate events.

c. Establishes a requirement that DoD contracting personnel request a contractor estimate of expenditures or other independent data to verify the performance-based payment events and amounts before approving the performance-based payment schedule. In addition, the guidance should require contracting personnel to review any expenditure profile data obtained.

d. Directs DoD contracting personnel to review open performance-based payment contracts with significant event values remaining to determine whether the performance-based payment amounts fairly represent event values. If the amounts do not represent the event value, contracting personnel should consult

their legal advisors to assess available corrective actions, including renegotiation of the performance-based payment amounts to comply with Federal Acquisition Regulation requirements.

Defense Pricing Comments

The Director, Defense Pricing, agreed and stated that his office will issue guidance addressing the topics contained in the recommendation. In a conversation subsequent to receiving management comments, Defense Pricing personnel stated that their office will issue guidance with an estimated completion date of September 2013.

Our Response

Comments from the Director, Defense Pricing on Recommendations A.1.a through A.1.d were responsive, and no additional comments are required.

2. Develop a performance-based training program that includes a discussion of appropriate performance-based payment events and require all DoD contracting personnel involved in the negotiation and award of performance-based payments to participate in the program. The training should specifically prohibit purchase orders, kickoff meetings, postaward conferences, entry events, passage of time, or the acceptance of end items as events.

Defense Pricing Comments

The Director, Defense Pricing, agreed and stated that the Defense Acquisition University recently deployed a 4-hour continuous learning module on PBPs and the value of cash flow. He also stated that he will direct contracting personnel to complete this continuous learning module as part of their continuous learning requirement effective FY 2014.

Furthermore, the Defense Acquisition University has developed an 8-hour lesson on PBPs that reinforces the information in the continuous learning module and also includes a two-part workshop that addresses the cited topics in this report. This lesson segment is currently a required course for Level II certification under the Defense Acquisition Workforce Improvement Act. In addition, the Director stated that this lesson, effective FY 2014, will be a required course for Level I certification, so contracting personnel will receive this training at the beginning of their appointment to contracting.

Our Response

Comments from the Director, Defense Pricing, on Recommendation A.2 were responsive, and no additional comments are required.

Finding B. Better Information in Contracts Would Improve Contract Administration

DoD contracting personnel did not include required administrative information that would have allowed responsible contracting personnel to properly administer PBPs. Specifically, for 46 of 60 PBP schedules, contracting personnel did not:

- include clearly defined success criteria for contractor performance as required by the FAR in 33 schedules,
- identify PBP events as either severable or cumulative as required by the FAR in 23 schedules, and
- specify completion dates for contractor performance as required by DoD guidance in 21 schedules.

These omissions occurred because DoD contracting personnel did not:

- determine whether the contractor-proposed event schedules met the specific FAR requirements,
- receive clear guidance related to the PBP contract financing award process for defining success criteria and a severable or cumulative event, and
- perform adequate reviews of PBP events because contracting personnel had not taken training specific to FAR requirements for PBP contract financing.

As a result, DoD contracting personnel could not readily determine whether the contractor performance was sufficient for payment. Therefore, ACOs had less information than needed when they determined whether the contractor successfully completed the PBP event. This put the Government at risk of making full payments for less than full contractor performance.

Contracting Personnel Excluded Required Administrative Information

DoD contracting personnel did not include required administrative information so that personnel could properly administer PBP events. Contracting personnel established PBP schedules that excluded appropriate performance success criteria, whether PBP events were severable or cumulative, and estimated completion dates. Contracting personnel must include this information in the PBP schedule so that the ACO can properly administer PBPs. Table 2 provides a summary of the 46 of 60 PBP schedules with missing or inadequate PBP event information.

Table 2. Missing or Inadequate Information in PBP Schedules

Missing or Inadequate Element	Number of Schedules
Verifiable success criteria	33
Severable or cumulative	23
Estimated event completion	21

Verifiable Success Criteria

DoD contracting personnel did not properly identify clearly defined success criteria for contractor performance for 33 schedules. For example, contracting personnel identified six events (ranging from requirements loaded into the system, to placement of 80 percent of purchase orders, to beginning of testing) with success criteria of "contractor certification submitted to DCMA ACO." This success criterion was inadequate because it did not provide a description of what constituted success, just that the contractor certified it was successful. For other sample contracts, contracting personnel did not include any event success criterion. See Figure C-2 in Appendix C for an additional example of the exclusion of success criteria.

This success criterion was inadequate because it did not provide a description of what constituted success, just that the contractor certified it was successful.

FAR 32.1004 requires that contracting officers describe what constitutes readily verifiable successful event performance. Examples of success criteria that comply with the FAR are the specific engineering requirements included in contract N61340-11-C-0006. For example, for the System Requirements Review event, contracting personnel required that the contractor obtain written concurrence that addressed all requirements in the technical approach, and the Government accepted all the requirements; the contractor mitigated all risks to the satisfaction of the Government, executed the program schedule within the anticipated cost and technical risks, and properly staffed the program.

Severable or Cumulative Events

DoD contracting personnel did not properly identify whether the PBP events were severable or cumulative for 23 schedules reviewed. For example, contract FA8223-09-C-0009, for C-5 maintenance and aircrew training systems, identified all 42 events as cumulative but did not identify how each event depended on other events. Specifically, contracting personnel identified event three (critical design review) as cumulative but did not identify that event three was dependent on the completion of event two (preliminary design review). For other sample contracts, contracting personnel did not identify any events as either severable or cumulative. See Figure C-2 in Appendix C for an additional example of excluding the severable or cumulative identity of a PBP event.

FAR 32.1004 states that the contracting officer must identify each event as either severable or cumulative. A severable event is independent of any other event. Conversely, a cumulative event depends on the successful completion of another event. If the contract identifies the event as cumulative, FAR 32.1004(a)(2) requires that it also identify the prior event on which it depends.

Estimated Event Completion

DoD contracting personnel did not identify when the contractor should complete PBP events for 21 schedules reviewed, as outlined in DoD guidance. The 2001 guidance states that parties (the PCO and contractor) need to identify when events are expected to occur in the event schedule. When the PCO included the estimated event completion date in the event schedule, the ACO would have more information to make a proper decision about whether the contractor successfully completed the event. See Figure C-2 in Appendix C for an additional example of excluding the estimated event completion date.

Improved Guidance and Required Training Needed

DoD contracting personnel did not include clear instructions for administering PBP events because DoD guidance was unclear, and contracting personnel had generally not taken PBP-specific contract financing training. Without training on the guidance, DoD contracting personnel were unaware of the FAR requirements for including success criteria and specifically identifying severable and cumulative events. Accepting the contractor's event schedules without ensuring compliance with the FAR was improper because DoD contracting personnel, not the contractor, were ultimately responsible for complying with FAR and DoD requirements.

Guidance Needed Clarification

DoD guidance related to PBP event success criteria and severable versus cumulative events needed clarification. Specifically, the 2001 guidance provides a brief definition of severable and cumulative events and description of success criteria. However, the guidance did not emphasize the importance of what a severable or cumulative event was and how and when a PBP event was successfully completed. The 2012 draft guidance has the same language for severable and cumulative events as in the 2001 guidance and does not provide examples of good success criteria. Therefore, the Director, Defense Pricing, needs to update the 2012 draft guidance to better define how and when a PBP event is successfully completed and provide examples of a severable or cumulative event. The Director also needs to distribute this guidance to all DoD contracting commands. As part of this guidance, Defense Pricing personnel should update the PBP contract financing checklist for the required event information.

PBP Training Needed

Contracting personnel should take PBP training to ensure compliance with FAR requirements. Of the 87 DoD contracting personnel interviewed, 24 stated they took elective PBP training. DoD guidance did not require any PBP-specific training, and the remaining 63 contracting personnel interviewed had not taken any PBP-specific training.

DoD contracting personnel indicated that PBP training would be helpful, as some lacked knowledge about a severable or cumulative event or successful performance criteria.

During the time the DoD contracts were awarded, the Defense Acquisition University offered an hour-long training course that provided a brief overview of PBP contract financing, which was based on the 2001 guidance. In addition, DoD contracting personnel took contracting classes that included only a brief section on PBP contract financing. However, DoD contracting personnel need more than just a brief overview of PBP contract financing, in order to adequately follow PBP requirements outlined in the FAR and Defense Pricing guidance. DoD contracting personnel involved in the establishment of PBP schedules need training in PBP contract financing that includes a discussion on the importance of adequate success criteria and the difference between a severable and cumulative event and the benefit of including estimated completion dates.

Enhanced Quality of Event Schedules Will Improve Payments

Without required event information in the contract, DoD contracting personnel could not readily determine whether the contractor performance was sufficient for payment. There were 46 contracts,[4] with PBPs valued at $10.6 billion, where the ACO had insufficient PBP event performance criteria available. Without complete and clearly defined performance payment requirements, DoD was at risk of making full payments when contractor performance was not successfully completed. The following examples highlight how ACOs approved PBP events without sufficient information.

Without complete and clearly defined performance payment requirements, DoD was at risk of making full payments when contractor performance was not successfully completed.

Adequacy of Success Criteria

If the contract did not adequately identify the success criteria, the ACO would not have enough information to determine whether the event was successfully completed. For example, one PBP schedule stated that the success criteria and verification method for determining that the contractor received materials would be contractor documentation validating the units were in stock and available for use. The ACO stated that they asked to perform physical verification of the items, but the contractor denied the request because verification was not required by the event schedule. The ACO stated that they then raised the issue to the organization's command level; ultimately, the contractor agreed to let the ACO perform a physical review. However, performing physical verification was difficult because of the event schedule wording. The ACO therefore ensured that the next contract included criteria in the PBP schedule that required the contractor to allow the ACO to perform physical inspection.

[4] This number is less than the individual errors because one contract could be missing more than one element.

Additionally, in this example, the physical inspection that was eventually performed identified that several events did not meet the verification criteria per the PBP event. Specifically, the ACO noted "suspect hardware" related to the event and therefore rejected the event until the contractor resolved the issue. This example showed that detailed PBP success and verification criteria could decrease the Government's risk of paying the contractor before successful event completion.

This example showed that detailed PBP success and verification criteria could decrease the Government's risk of paying the contractor before successful event completion.

In another example, the PBP schedule did not include event success criteria and the ACO's verification method. This resulted in both the contractor and the ACO potentially making uninformed decisions about whether the contractor successfully completed an event. Specifically, the contractor provided the following in e-mail format as support for the successful completion of an event: "Based on the physical completion (7-8 April 2010) and the submitted CDRL [contract data requirements list] … with detailed attendee list I feel that this constitutes completion of Milestone [event] #1.…" He continued, "As the Project Manager for this effort with in-depth knowledge of the engineered solution, schedule, current progress, and the way forward, I certify to the best extent of my knowledge that Milestone [event] #1, "Start Training" has been accomplished. …" In addition, the Government project director stated that because the bi-weekly slides showed the contractor was currently testing the item, the contractor must have completed the production event. The absence of success criteria resulted in both the contractor and the ACO making a judgment without all necessary information, therefore putting DoD at risk when the ACO approved the PBP event without the success anticipated.

Event Completion Dates Can Help Determine Successful Event Performance

If the contract includes PBP event completion dates, the ACO can use that information to readily determine if the contractor successfully completed the PBP event by comparing the actual completion date with the scheduled completion date. This is effective, however, only when contracting personnel based the scheduled completion dates on realistic performance levels required for successful contract completion. For example, a revised PBP schedule for sonobuoys[5] included estimated PBP event completion dates as "no later than" dates. However, the estimated period of performance of up to 5 months far exceeded the actual completion period of 1 day. Specifically, the contractor submitted a payment request, representing 50 percent of the PBP schedule value, for an event completed 5 months before the PBP estimated "no later than" completion date.

[5] Sonobuoys are noncommercial, aircraft-launched, expendable floating devices used to detect acoustic emissions or reflections from potentially hostile submarines; the sonobuoys then transmit those signals to U.S. Navy airborne antisubmarine warfare forces.

The ACO verified that the payment request amount matched the PBP event amount but did not question why the contractor completed the event 5 months before the estimated date. Had the ACO reviewed the difference in dates to determine why the contractor was able to complete the event so much sooner than anticipated, this information could have been used to ensure the performance level for this and other events was appropriate for the scheduled events.

In summary, as shown in the examples, without adequate information in the PBP schedules, DoD was at risk for paying for potentially inadequate contract performance, as the ACO was making decisions without all pertinent information.

Recommendations, Management Comments, and Our Response

B. We recommend that the Director, Defense Pricing:

1. Update 2012 draft guidance that:

a. Defines how and when a performance-based payment event is successfully completed,

b. Defines what comprises a severable or cumulative event, and

c. Updates the contract financing checklist to ensure the entire required event elements are included in the performance-based payment schedule.

Defense Pricing Comments

The Director, Defense Pricing, agreed and stated that his office will update the 2012 draft "Performance Based Payments Guide – The Better Buying Power Initiative" to address the issues cited before releasing for final publication. In a conversation subsequent to receiving management comments, Defense Pricing personnel stated that their office will update the guidance with an estimated completion date of September 2013.

Our Response

Comments from the Director, Defense Pricing, on Recommendations B.1.a through B.1.c were responsive, and no additional comments are required.

2. Develop a performance-based payment contract financing training program that:

a. Includes a discussion on successful completion criteria, severable and cumulative events, and the need for estimated event completion dates tailored to performance levels required for contract completion, and

b. Is required of all DoD contracting personnel involved in the negotiation, award, and administration of performance-based payments.

Defense Pricing Comments

The Director, Defense Pricing, agreed and stated that the Defense Acquisition University recently deployed a 4-hour continuous learning module on PBPs and the value of cash flow. He also stated that he will direct contracting personnel to complete this continuous learning module as part of their continuous learning requirement effective FY 2014.

Furthermore, the Defense Acquisition University has developed an 8-hour lesson on PBPs that reinforces the information in the continuous learning module and also includes a two-part workshop that addresses the cited topics in this report. This lesson segment is currently a required course for Level II certification under the Defense Acquisition Workforce Improvement Act. In addition, the Director stated that this lesson, effective FY 2014, will be a required course for Level I certification, so contracting personnel will receive this training at the beginning of their appointment to contracting.

Our Response

Comments from the Director, Defense Pricing, on Recommendation B.2.a and B.2.b were responsive, and no additional comments are required.

Finding C. Contracting Personnel Should Verify Whether Contractors Needed Contract Financing

DoD contracting personnel negotiated and awarded contracts that authorized PBPs without appropriately verifying the contractors' contract financing need or level of investment in the contract for 60 of the 60 sample contracts.

This occurred because DoD provided inaccurate and inadequate guidance related to PBP usage and valuation criteria. Specifically, the guidance:

- did not specify which contract financing method was preferred or define reasonable contractor investment,
- misrepresented the FAR requirement that PBPs be provided only to the extent necessary, and
- indicated that including profit in the PBP amounts was acceptable.

As a result, there was increased risk that a portion of the $28.8 million in carrying costs associated with the $7.5 billion in PBPs that DoD paid contractors for the sample contracts should not have been paid but instead could have been put to better use. Furthermore, if the same issues applied to the $15.8 billion in disbursements for other open PBP contracts, a portion of the calculated $88.8 million in carrying costs might have been put to better use. Specifically, we calculated that DoD included between $2.9 million to $3.3 million in profit carrying costs for the sample contracts. This amount could be between $5.3 million and $12.8 million for the remaining contracts.[6] Further, if DoD ensured that the contractor had a reasonable level of investment in the contract, DoD could have saved between $1.0 million and $20.1 million of additional carrying costs. In addition, by automatically including PBP financing at the beginning of the contract, contracting personnel limited DoD's ability to ensure it received adequate consideration.

If contracting personnel ensured that PBP event values did not include profit and that contractors had a reasonable level of investment, the Government could realize potential monetary benefits from between $13.6 million and $53.3 million over the next 5 years related to reduced carrying costs. Costs could be reduced by an additional amount if contracting personnel verified whether, and to what extent, contractors should receive financing payments before contract award.

Contracting Personnel Did Not Verify Whether Contract Financing Was Necessary

DoD contracting personnel did not comply with the FAR by verifying each contractor's need for contract financing before negotiating and including the PBP schedules in contracts. Specifically, when DoD contracting personnel considered the use of PBPs, they did not first determine whether the contractor could obtain private contract financing at a reasonable rate, whether the

[6] See Appendix A for the calculation.

contract fit within the minimum requirements for contract financing, and to what extent the contractor needed financing to complete the contract successfully, as required by the FAR. Table 3 shows a breakout of the specific FAR requirements that contracting personnel did not consider for 60 of the 60 contracts.

Table 3. Financing Requirements That Were Not Considered

Requirement	Number of Contracts
Private financing available	60
Under the FAR timeframe and dollar value threshold	11
Need of contract financing and level of investment	60

Determination of Non-Government Financing

Contracting personnel did not determine whether the contractor could obtain private financing for 60 of 60 contracts reviewed, as required by the FAR. FAR 32.106 states that the contracting officer must consider private financing, as long as the private financing terms are reasonable and are not from other agencies.[7] If private financing is not available to the contractor at reasonable rates, the Government may then consider using customary contract financing, with PBPs being the preferred customary contract financing, if applicable. Contracting personnel did not determine whether the contractors could obtain private financing despite the Government awarding 35 of the 60 contracts to the 10 largest DoD contractors.[8] For example, DoD contracting personnel provided a top 10 contractor with $4.2 billion in PBP contract financing without determining whether that contractor could obtain non-Government financing. Based on the volume of work performed by that contractor and the other nine, it could be possible for some of them to obtain private financing.

DoD contracting personnel provided a top 10 contractor with $4.2 billion in PBP contract financing without determining whether that contractor could obtain non-Government financing.

Contracts Did Not Meet Required Timeframe or Dollar Value Threshold for Contract Financing

DoD contracting personnel awarded PBP financing on 11 contracts that did not meet the minimum standard to receive any contract financing. For example, on one contract, contracting personnel inappropriately provided PBP financing to a contractor where the negotiated contract price was $250,000, which was 10 percent of the FAR minimum requirements. Contracting personnel justified the use of PBP financing because the contractor had performed some work on the contract before contract award.

The FAR provides minimum requirements for providing PBPs to contractors. Specifically, FAR 32.104 states that the contracting officer may provide PBP contract financing if the contractor will not be able to bill for the first delivery of products for a substantial time after the contractor begins work (usually 6 months or more) and the contract price is $2.5 million or

[7] The FAR states that the contracting officer can make case-by-case exceptions if they are in the Government's best interest.
[8] Top 10 contracts were determined based on amounts DoD obligated to the contractors throughout FY 2011.

more.[9] Therefore, contracting personnel should not award PBP financing on contracts that do not meet this minimum standard.

Contracting Personnel Did Not Provide Contract Financing Only to the Extent Necessary or Require a Reasonable Contractor Investment

DoD contracting personnel did not verify whether the PBP financing amounts provided for 60 contracts were in accordance with FAR requirements. FAR 32.104 states that contracting officers should provide financing only to the extent actually needed for prompt and efficient performance, considering the probable impact on working capital or the predelivery expenditures and production lead times. In addition, FAR 32.1004 requires that the PBPs reflect prudent contract financing; that is, provided only to the extent needed for contract performance and not to exceed 90 percent of the acquisition. Finally, FAR 32.1004 states that PBP amounts are not expected to result in an unreasonably low or negative level of contractor investment in the contract. In simpler terms, this means the contracting officer should ensure that the contractor assumes some level of financial risk in the contract. In addition, FAR clause 52.232-28 states that the contractor's proposal of PBP financing is to include information addressing its investment in the contract. The FAR does not specify what information the contractor should include related to its investment.

Specifically, contracting personnel did not verify how much contract financing the contractor needed, or whether the contractor had a reasonable level of investment. Instead, contracting personnel automatically provided contract financing at the maximum amount allowable under the FAR. As a result, contracting personnel provided PBP amounts that included profit, and which were therefore likely in excess of the contractor's actual financing needs and not necessary for successful contract performance. In addition, by providing the maximum amount of contract financing allowable under the FAR, contracting personnel also awarded PBP schedules that created a negative or unreasonably low level of contractor investment in the contract.

Including Profit Is Not Necessary for Successful Contract Performance

When DoD contracting personnel awarded contractors with 90 percent PBP financing in 46 of 60 contracts, they included profit with the PBP values. Specifically, 29 contracts that allowed 90 percent contract financing included profit of 10 percent or more, which called into question whether the contractor truly needed the maximum contract financing amount for successful contract performance. For sample contract W31P4Q-10-C-0132, DoD contracting personnel negotiated a profit rate of 16.9 percent and approved the PBP event values totaling 90 percent of the contract value. However, the contractor incurred costs for only 85.6 percent of the contract value. When DoD contracting personnel allowed PBP events valued at 90 percent of the contract value, they included profit and financed the contractor at 105.2 percent of the contractor's total

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[9] The FAR defines less stringent criteria for small businesses. In our sample, four small businesses met the less stringent FAR criteria. We did not include them in our discussion. In addition, there are other criteria such as determining whether the expenditures will have a significant impact on the contractor's working capital fund. The audit did not include tests for this requirement. See "Contracting Personnel Did Not Provide Contract Financing Only to the Extent Necessary or Require a Reasonable Contractor Investment" for discussion on contractor need.

costs. Therefore, DoD contracting personnel provided the contractor with a positive cash flow, which would not appear to be necessary for successful completion of the contract.

In another example, a contractor submitted a PBP request that brought the total of PBP payments to $1.848 billion. However, according to the contractor's cash flow analysis, the cumulative costs at that time were only $1.601 billion. Therefore, at the time the contractor submitted a payment request, the contractor estimated receipt of a positive cash flow of $247 million, or 15.4 percent more than its incurred costs. It is unlikely that cash flow in excess of actual costs was needed for successful contract performance as required by the FAR.

Ensuring a Reasonable Contractor Investment Is Required

When DoD contracting personnel awarded 57 of the 60 sample contracts containing the PBP schedules, they did not verify that the contractor had a reasonable level of investment, as required by the FAR. Specifically, when contracting personnel provided the contractor with financing for the contractor's entire incurred costs to date, the contractor had zero investment in the contract. When contracting personnel provided the contractor with financing for more than the contractor's incurred costs, the contractor had a negative investment in the contract. These actions contradicted the FAR expectation that contractors assume some level of financial risk in the contract.

Although contracting personnel negotiated contractor profit rates, not only did they not consider the negotiated profit rates to determine what amount of PBP financing was necessary for successful performance but also did not consider the impact of the profit rates on the contractor's level of investment in the contract. For example, in contract W31P4Q-11-C-0001 for Patriot missiles, DoD contracting personnel negotiated an effective profit rate of 13.0 percent and provided the contractor with 90 percent contract financing. When the profit rate exceeds the liquidation rate it indicates the contract financing includes some portion of the profit, if not a proportional rate of profit depending how the profit is liquidated in a contract. Including the profit in the PBP values meant that the contractor actually had a negative investment in the contract because the Government provided more financing than the contractor's incurred costs.

In this example, the data showed that DoD contracting personnel allowed the contractor to include the entire 13.0 percent profit with each PBP payment. Therefore, in this contract, DoD contracting personnel provided the contractor with a negative investment of 13.0 percent because contracting personnel included profit with each payment rather than at the contract's completion.

Contracting Personnel Relied on Inadequate and Inaccurate DoD Guidance

DoD contracting personnel did not determine contractors' financing needs before awarding the contracts because of inaccurate and inadequate DoD guidance. Specifically, the 2001 guidance is limited and only discussed specific concepts regarding PBPs, including when to use PBP financing on contracts, how to establish and value PBP events, and how to liquidate PBP payments.

However, the guidance misrepresented specific criteria in the FAR, and did not provide DoD contracting personnel with a complete basis for negotiating, awarding, and administering the contracts.

Specifically, the guidance:

- lacks instructions for DoD contracting personnel to determine which financing method was preferred,
- lacks instructions for DoD contracting personnel to determine what a reasonable level of contractor investment was, and how to determine the level of investment,
- misrepresents the FAR requirement for providing PBPs only to the extent necessary, and
- indicates that including profit in the PBP amounts was acceptable.

Expanded Guidance Needed to Determine Financing Methods

The 2001 guidance lacks instructions for DoD contracting personnel to determine which financing method contracting personnel should use. Specifically, the guidance stated only that the use of PBP financing is the Government's preferred method of financing for fixed-price contracts. However, it should have included a discussion that DoD contracting personnel must first consider whether the contractor could obtain private contract financing, as required by the FAR. FAR Part 32.106, "Order of Preference," specifically requires contracting officers to consider whether private financing is available at reasonable terms, outside of the Government. If private financing at reasonable terms was unavailable to the contractor, the contracting officer could consider customary contract financing, with PBPs being the preferred method of customary contract financing.

Defense Pricing Draft Update to PBP Guidance Improves Financing Instructions

The 2012 draft guidance added the FAR requirement for contracting officers to consider the contractor's need for financing by highlighting the FAR order of preference, where "private financing without Government guarantee" is the preferred Government financing. The draft PBP guidance adds, "from a business perspective, the FAR order of preference is entirely logical." Although the draft guidance included the FAR order of preference, the updated guidance may mislead users into concluding that PBP financing should always be used. Specifically, the guidance states, "Although the first preference is that no Government contract financing be provided, the Government provides contract financing on the vast majority of fixed price, non-commercial contracts when deliveries are scheduled to begin six months or more after contract award." Therefore, Defense Pricing personnel should update and finalize the 2012 draft guidance to provide detailed guidance on how to determine whether there is a need for contract financing. Specifically, the updated guidance should require contracting personnel to review a contractor's financial information and determine the contractor's ability to obtain private financing at a reasonable rate before allowing PBP financing.

Guidance Needed to Clarify a Reasonable Level of Contractor Investment

DoD contracting personnel repeatedly stated that they did not have any guidance to rely upon when negotiating the total amount of PBP contract financing. Specifically, DoD contracting personnel provided excess funding to contractors because guidance did not exist to determine what an unreasonably low or negative level of contractor investment in the contract should be.

DoD guidance did not require that contractors must have a reasonable level of investment, as expected by the FAR. Specifically, the 2001 guidance incorrectly advises that because contractor cost was likely to be less than 90 percent of the negotiated price, PBPs were likely to include profit. This guidance would lead the reader to presume that PBPs should always equal the FAR maximum threshold and ignored other, limiting FAR language. The guidance mentioned that the contracting officer should ensure the contractor did not have an unreasonably low or negative level of investment in the contract, but did not provide specific guidance on how to determine the appropriate, reasonable level of investment. In addition, the 2001 guidance accepts profit in the PBPs.

> *This guidance would lead the reader to presume that PBPs should always equal the FAR maximum threshold and ignored other, limiting FAR language.*

The 2012 draft guidance recognizes that the 2001 guidance is incorrect and states that the contracting officer should not include profit when providing PBP payments. We agree with this policy change and note that additional changes are needed. Specifically, the draft guidance does not define "unreasonably low" level of investment or how to ensure that the contractor had a reasonable level of investment. In addition, the draft guidance does not reference FAR clause 52.232-28, which requires the contractor to provide the contracting officer with information about its level of investment in the contract. Therefore, Defense Pricing personnel should develop guidance that defines what an "unreasonably low" level of contractor investment in the contract is and how to determine contactor investment. In addition, they should provide guidance on how to use FAR clause 52.232-28 to obtain information on contractor investment.

Guidance Should Restrict Financing to Extent Necessary

DoD contracting personnel did not provide PBP financing only to the extent necessary for successful contract completion because they relied on DoD guidance, which would lead the reader to presume that PBPs should always equal the FAR maximum threshold and ignored other limiting FAR language. The 2001 guidance states "PBPs can be made for up to a specified portion of the contract's or line item's price (currently 90%), whereas traditional progress payments are limited to a fixed percentage of incurred cost (currently 80% for DoD). . . . [PBPs] can have a substantial positive cash-flow advantage for a contractor."

The 2001 guidance provides DoD contracting personnel with a hypothetical example that assumed the use of a 90 percent financing rate and inclusion of profit. This guidance was silent on the FAR requirement that contracting officers should provide financing only to the extent necessary.

The guidance should have included a discussion that 90 percent was the maximum limit, and contracting personnel should provide financing only to the level needed for successful performance.

Defense Pricing Draft 2012 Update of 2001 PBP Guidance Improves Instructions on Financing Rates

The 2012 draft guidance clarifies the importance of determining the extent to which PBP financing is provided. The draft guidance explicitly states that "it is important to note that 90% is the maximum that can be provided and not the default level of PBP financing." In addition, the draft guidance correctly acknowledges that PBPs require considerable upfront time and effort between both parties to determine "win-win" financing values. The Defense Pricing personnel should update and finalize the DoD guidance to provide examples of how DoD contracting personnel should determine when a financing rate less than the maximum 90 percent would be appropriate.

Guidance Incorrectly Encouraged Including Contractor Profit in Event Values

The 2001 guidance incorrectly advises contracting officers to allow negotiated profit to be included in the PBP amounts. Specifically, the guidance incorrectly suggested that "since in most fixed-priced contract situations the contractor's costs of performance are likely to be less than 90% of the negotiated price, PBPs are likely to afford the contractor a small amount of profit beyond that initially contemplated." This guidance conflicted with a proper interpretation of FAR 32.1004, which requires contracting officers to ensure the PBPs reflect prudent contract financing provided only to the extent needed for contract performance and not to exceed 90 percent of the acquisition. Providing profit generally should not be necessary for successful contract completion.

Defense Pricing 2012 Draft Update of 2001 PBP Guidance Improves Compliance With FAR

The 2012 draft guidance states that the previously issued guidance, which advised contracting officers that because "contractor cost is likely to be less than 90% of the negotiated price, PBPs are likely to include profit," was incorrect. Additionally, in an example comparing progress payments to PBP calculations, the 2012 draft guidance makes this express point: "Under progress payments the contractor is appropriately provided all profit earned, but only upon delivery, not as part of contract financing. Since PBPs are a type of contract financing, payment of profit is still only appropriate upon delivery." The updated guidance better aligns its discussion of financing rates to the intent of the PBP requirement in FAR 32.1004. As Defense Pricing personnel update and finalize the draft guidance, they should include the requirement that PBP values should not include profit.

DoD May Have Incurred Unnecessary Costs and Not Received Adequate Consideration

When contracting personnel provided contract financing without adequately assessing contractors' financial need, DoD may have unnecessarily incurred significant carrying costs and limited DoD's ability to ensure it received adequate consideration for providing the financing.

DoD Incurred Carrying Costs on Financing Payments

DoD incurred carrying costs associated with contract financing payments. These carrying costs were the result of the Treasury borrowing funds to make the payments. The current interest rate reported by the Treasury is 1 percent. The rate has fluctuated between 1 percent and 5 percent from CY 2007 through CY 2012. Therefore, to minimize costs, DoD should not provide more PBPs than necessary for successful contract performance. Specifically, DoD should, at a minimum, negotiate the PBP schedule to ensure the Government does not finance profit and that the contractor bears a reasonable level of investment.

For 60 of the 60 sampled contracts, contracting personnel did not adequately determine whether PBPs were necessary. These contracts had PBP disbursements totaling $7.5 billion as of May 16, 2012, with calculated interest-based carrying costs of $28.8 million as of May 16, 2012. We determined the carrying costs using the time between the PBP payment and the date the PBP financing was liquidated. If the PBP financing had not been liquidated, we calculated the carrying costs through May 16, 2012. For example, one sample contract with $1.6 billion in PBP disbursements had a total of $12.3 million in carrying costs. For this contract, contracting personnel did not determine whether the contractor needed financing because contracting personnel provided the contractor PBP financing for similar prior contract awards.

There were an additional 570 open U.S.-funded contracts with a total of $15.8 billion of PBP payments as of May 16, 2012, and a calculated $88.8 million in carrying costs. See Appendix A for additional details of determining carrying costs.

Excluding Profit from PBP Payments Would Reduce Carrying Costs

Of the $28.8 million in carrying costs related to the 60 contracts, between $2.9 million and $3.3 million of the carrying costs related to improperly funding the contractor's profit. In addition, assuming a low profit rate of 6.0 percent to a high profit rate of 14.4 percent as identified in the sample, DoD could have incurred carrying costs related to funding contractors' profit of between $5.3 million and $12.8 million of the $88.8 million carrying costs of the remaining contracts. See Appendix A for details on our methodology.

> *… between $2.9 million and $3.3 million of the carrying costs related to improperly funding the contractor's profit.*

Ensuring Reasonable Level of Investment Would Reduce Carrying Costs

In addition to ensuring that profit was not included in the PBP values, contracting personnel could further reduce carrying costs by requiring that contractors have a reasonable investment in the contract. The FAR requires that DoD ensure that the contractor not have an unreasonably low level of investment in the contract.

When DoD personnel determine a reasonable level of investment for a contractor, the carrying costs would be reduced accordingly because the PBP event values would be reduced by the contractor investment. Table 4 provides a breakout of the carrying costs that could be reduced depending on what level of investment the DoD guidance establishes.

Table 4. Potential Reduced Carrying Costs Related to Reasonable Investment

Percent of Costs Considered Reasonable Investment for Contractor to Carry	**Sample Contracts** (calculated carrying costs of $28.8 million)	**Remaining Universe** (calculated carrying costs of $88.8 million)	**Total** (in millions)
1	$0.2	$0.8	$1.0
5	1.2	3.8	5.0
10	2.4	7.6	10.0
20	4.9	15.2	20.1

Specifically, in Table 4, we calculated the reduced carrying costs assuming a 1-percent level of contractor investment through a 20-percent level of investment. We included a 20-percent level of investment in the example because the other common contract financing process (progress payments based on costs) limited payment to nonsmall businesses to 80 percent of incurred costs. Additionally, we assumed that contracting personnel did not already negotiate the PBP amounts with a reasonable level of contractor investment.

Potential Monetary Benefits Could Be Realized

If contracting personnel ensured that PBP event values did not include profit and that contractors had a reasonable level of investment, the Government could realize potential monetary benefits from between $13.6 million and $53.3 million related to reduced carrying costs. Costs could be reduced by an additional amount if contracting personnel verified whether, and to what extent, contractors should receive financing payments before contract award.

The potential monetary benefits we calculated were funds that could be put to better use and were based on the past trend of profit, reasonable investment carrying costs, and calculated PBPs over the next 5 years. We could not calculate the additional potential monetary benefits related to DoD's assessment of how much contract financing it should provide contractors. Finally, because the potential monetary benefit associated with carrying costs is related to the U.S. Treasury, no specific DoD appropriation is benefitted. See Appendix A for our specific methodology for calculating potential monetary benefits.

Determining Whether Adequate Consideration Was Received for Providing PBPs

Contracting personnel automatically included contract financing in 48 of the 54[10] sole-source awarded sample contracts by inserting FAR clause 52.232-32 at contract inception. By doing this, they limited their ability to ensure they received adequate consideration for providing contract financing. FAR 32.005, "Consideration for Contract Financing," states that when the contracting officer includes a contract financing clause at contract inception there shall be no separate consideration, and the value of contract financing is expected to be reflected in either a lower price or more favorable contract terms and conditions than without contract financing.

The FAR provides that contracting officers evaluate the adequacy of contractor consideration in other financing circumstances. Specifically, FAR 32.005 states that the contracting officer

[10] Of the 60 sample contracts, the remaining 6 were competitively awarded.

should evaluate whether new consideration is adequate when there are changes to, or the addition of, contract financing after award. Therefore, if contracting personnel had not automatically included PBP financing in the original negotiation terms, they could have evaluated the appropriateness of contractor consideration at the time when contract financing terms were added.

The FAR 32.005 expectation of adequate financing consideration appears appropriate in a competitively awarded, fixed-price contract, because a low price (or more favorable terms) is generally an important factor in ensuring a successful competitive bid or contract award. However, for contracts that DoD awards sole-source (noncompetitively), the contractor may not have the same incentive to provide DoD a lower price based on the value of contract financing, especially where the need for financing has not been established. Contracting personnel awarded 48[11] of the 54 sampled contracts sole-source, without ensuring adequate consideration for authorizing PBPs.

If contracting personnel did not automatically authorize PBPs at contract inception for sole-source contracts, DoD could better protect its interests by reviewing the proposed consideration in detail. For example, contracting personnel included FAR clause 52.232-32 in the solicitation for sample contract N00019-09-C-0019, and contracting personnel had to assume that the contractor provided DoD consideration for the PBP financing. Had contracting personnel adequately determined the need for financing after the solicitation, DoD could have ensured it received adequate consideration from the contractor for the $12.3 million in estimated Government carrying costs associated with this contract.

If contracting personnel did not automatically authorize PBPs at contract inception for sole-source contracts, DoD could better protect its interests.

2012 Draft Guidance Needs Improvement

The 2012 draft guidance highlights the importance of the cost of money when providing PBP financing, and it states that the PCO should view the cost of money as a "win-win deal," where the Government can negotiate a lower contract price based on the improved cash flow provided with PBPs to the contractor. Defense Pricing personnel established a "PBP Analysis Tool" to quantify the benefits provided to the contractor through the PBP financing and to ultimately receive comparable consideration to obtain a "win-win deal."

The increased focus on a "win-win deal" in the updated guidance is a step in the right direction for DoD to ensure the Government considers the cost of money and adequate consideration when it provides PBP financing. However, the 2012 draft provides guidance only on calculating the cost of money and receiving consideration when the contract changes from progress payments to PBPs.

Significant value could be realized if the 2012 draft guidance had identified that contracting personnel did not need to provide any contract financing in sole-source acquisitions until the

[11] While the remaining six sole-source contracts also included the PBP clause at contract inception, the contracting personnel still ensured that they received consideration for authorizing PBPs.

contractor demonstrated a need for financing because contracting personnel could then better ensure that they received adequate consideration for providing contract financing.

Recommendations, Management Comments, and Our Response

C. We recommend that the Director, Defense Pricing issue guidance requiring contracting personnel to:

1. **Determine whether the contractor can obtain private financing at a reasonable rate before allowing PBP financing.**

2. **Determine an appropriate financing rate. This determination should include guidance on how to use Federal Acquisition Regulation clause 52.232-28 to obtain information on contractor investment and a definition of what a reasonable level of contractor investment is, understanding that performance-based payment events should not generally include contractor profit.**

3. **Refrain from including the Federal Acquisition Regulation clause 52.232-32 at contract inception for sole-source contracts, unless they have sufficient evidence that the contractor needs contractor financing. This will help ensure that DoD receives adequate consideration for contract financing in sole-source acquisitions.**

Defense Pricing Comments

The Director, Defense Pricing, agreed and stated that his office will issue guidance addressing the topics contained in the recommendation. In a conversation subsequent to receiving management comments, Defense Pricing personnel stated that their office will update the guidance with an estimated completion date of September 2013.

Our Response

Comments from the Director, Defense Pricing, on Recommendations C.1 through C.3 were responsive, and no additional comments are required.

Appendix A. Scope and Methodology

We conducted this performance audit from March 2012 through February 2013 in accordance with generally accepted Government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

To accomplish our audit objectives, we coordinated with and interviewed contracting personnel from the Army, Navy, Air Force, and DCMA. We obtained and reviewed FAR 32, "Contract Financing," and FAR Subpart 32.10, "Performance-Based Payments," as they relate to contract financing and PBPs.

Sample Selection

We obtained the DFAS Columbus Mechanization of Contract Administration Services records, which contained 770 open PBP contracts, with $27.9 billion in disbursements through May 16, 2012. The 770 contracts represented 39 separate contracting locations. We nonstatistically selected 60 of the 770 contracts for our sample. We selected the contracts from seven high-dollar sites and selected contracts based on review of high risk. The contracts were awarded from FY 2009 through FY 2011. We included Army, Navy, and Air Force contracts based on PBP contract volume. We excluded the Marine Corps and other Defense agencies from the sample because they encompassed a small percentage of payments. The contracts were either solely funded by DoD, funded for Foreign Military Sales, or a combination of both. Table A-1 shows how many contracts DoD funded itself or for which it used Foreign Military Sales funds.

Table A-1. Types of Contract Funding

Contract Funding	Number of Contracts
Solely funded by DoD	42
DoD use of Foreign Military Sales funds	8
Combination of U.S. and Foreign Military Sales	10
Total	**60**

We conducted site visits at seven contracting locations for eight separate contracting offices. Specifically, TACOM in Michigan, U.S. Army Redstone Arsenal in Alabama, U.S. Army Aberdeen Proving Ground in Maryland, U.S. Army Program Executive Office for Simulation, Training, and Instrumentation in Florida, Naval Air Station Patuxent River in Maryland, Naval Air Warfare Center in Florida, Eglin Air Force Base in Florida, and Hill Air Force Base in Utah.

We interviewed contracting personnel for each contract and obtained documentation to determine how the PBPs were negotiated. We also interviewed contracting personnel for each contract and obtained documentation to determine how they verified that contractors successfully completed the events before payment. In addition, we obtained and reviewed the 60 contracts and supporting documentation to determine whether they were in compliance with the FAR and DoD requirements.

Carrying Costs and Reasonable Investment Methodology

We used the universe provided by DFAS Columbus to calculate the amount of carrying costs. We calculated the carrying costs from the date the PBP payment was made to the date that the delivery invoice was paid. If the invoice had not yet been paid, we calculated carrying costs as of May 16, 2012. We used the 1-percent yearly interest rate provided by the U.S. Treasury in the determination. For instance, if a PBP was made to a contractor in the amount of $1 million and the delivery was not made until 180 days later, we would calculate the carrying costs as $4,931.51 for that transaction (180 days/365 days x .01 Treasury rate x $1 million).

We used the calculated carrying costs to determine the costs incurred to finance the profit portion of the PBPs. We determined the carrying cost for each sample contract reviewed and multiplied that figure by the profit rate negotiated for the contract. This calculation took into account an equal amount of profit liquidated with each PBP made as a high range, and the difference between the profit rate and PBP withholding as the low range. To demonstrate the possible magnitude of the nonsample items, we then applied the greatest and lowest profit rates identified in our review to the overall carrying costs for the applicable nonsample open contracts. For this calculation, we used 6.0 percent as the lowest rate and 14.4 percent as the highest profit rate observed. This is not a statistical estimate but rather an analytical calculation to determine the possible dollar magnitude.

For the reasonable investment methodology, we took a straight percentage of the carrying costs.

Potential Monetary Benefits

We calculated the potential monetary benefits by analyzing the carrying costs related to the PBPs that financed contractor profit and our calculation of a reasonable level of contractor investment for the open PBP contracts. (See paragraph above for our carrying costs methodology). The carrying costs were related to contracts with PBP disbursements that were awarded from FY 2009 through FY 2011. DFAS paid the disbursements between December 5, 2008, through May 16, 2012, which is 3.4 years. Therefore, we took the total amount of carrying costs related to profit and reasonable investment and divided that amount by 3.4 to obtain a yearly amount. We then multiplied the yearly amount by 5 to calculate the potential monetary benefit that could be realized if DoD contracting personnel implement additional controls. See Table A-2 for specific calculations.

Table A-2. Potential Monetary Benefits Calculations
(in millions)

Range	Profit Carrying Costs for		Reasonable Investment for Sample and Nonsample	Total Carrying Cost for Profit and Reasonable Investment	Yearly Calculated Carrying Cost	5-Year Potential Monetary Benefit
	Sample[12]	Nonsample				
Low	$2.9	$5.3	$1.0	$9.2	$2.7	$13.6
High	3.3	12.8	20.1	36.2	10.7*	53.3*

*The calculations were based on actuals and the amounts in the table may differ because of rounding.

Use of Computer-Processed Data

We used computer-processed data from the Mechanization of Contract Administration Services system to determine our universe, select our sample contracts, and calculate the carrying and administrative costs. We also used computer-processed data from the Wide-Area Work Flow system. We assessed the reliability of the data by ensuring that the computer-processed data from our sample selection was supported by independent documentation. From this testing, we determined that the data were sufficiently reliable for the purposes of our analysis.

Use of Technical Assistance

The DoD OIG Quantitative Methods Division assisted with the audit. Specifically, Quantitative Methods Division personnel provided support and assistance in recalculating and verifying the carrying cost amounts for the nonsample items, as described in Appendix A.

Prior Coverage

During the last 5 years, there were no reports issued discussing the negotiation, award, and administration of PBPs.

[12] The low-range carrying cost of profit was derived from multiplying the carrying cost from each sample contract to the effective profit percentages multiplied by the PBP liquidation rate. The high range was determined by multiplying the carrying cost for each sample contract by the effective profit percentage.

Appendix B. List of 60 Sample Contracts

Ordering Activity	Contract Number	Total PBP Event Values (in millions)	Total PBP Paid (in millions)	Total Carrying Costs (in thousands)	Condition*			
					A	B	C	D
TACOM, Michigan	W56HZV09D0116 0006	$42.1	$22.8	$72.0	X	X	X	X
	W56HZV09D0024 0048	2.3	2.3	9.3	X	X		X
	W56HZV09C0311	56.1	42.2	344.4	X	X	X	X
	W56HZV09CB014	5.0	4.4	11.7	X	X	X	X
	W56HZV10C0399	1.4	0.8	3.8	X	X	X	X
	W56HZV10C0263	9.7	9.7	44.5		X	X	X
	W56HZV10C0238	12.3	11.1	49.0	X	X	X	X
	W56HZV11P0659	0.3	0.2	1.1	X	X	X	X
	W56HZV10C0301	0.5	0.5	3.0		X	X	X
U.S. Army Redstone Arsenal, Alabama	W31P4Q09G0001 0002	2,523.1	2,268.1	0	X		X	X
	W31P4Q11C0001	959.1	474.2	190.5	X			X
	W31P4Q09C0002	660.9	651.6	1,975.8	X	X		X
	W31P4Q09G0002 0001	129.1	97.4	0	X		X	X
	W31P4Q09G0001 0001	103.4	59.8	0	X		X	X
	W31P4Q10C0132	51.1	39.3	264.6	X		X	X
	W31P4Q09G0002 0003	92.1	41.9	0	X		X	X
	W31P4Q09C0321	29.1	20.8	0	X		X	X
	W31P4Q10C0301	24.6	17.8	155.5	X		X	X
	W31P4Q11C0084	130.6	26.4	0	X	X	X	X
	W31P4Q09C0001	383.4	288.1	1,909.1	X		X	X
	W31P4Q10C0270	372.4	303.2	1,864.0	X			X
	W58RGZ09C0147	187.6	145.0	0	X	X	X	X

*Condition:
A – Approval of inappropriate events (See report page number 5, Table 1 for further discussion.)
B – PBP Amount Not Representative of Event Values (See report page number 8, "Performance-Based Amounts Were Not Commensurate With Event Values" for further discussion.)
C – Missing required elements (See report page number 14, Table 2 for further discussion.)
D – Unnecessary use of PBP contract financing (See report page number 20, Table 3 for further discussion.)

Appendix B continued

U.S. Army Aberdeen Proving Ground, Maryland	W15P7T11CH466	16.2	14.3	45.5	X	X	X	X
	W15P7T10DS229 0001	6.4	6.4	48.7	X	X		X
	W15P7T11DH001 0001	2.8	1.3	7.8	X	X	X	X
	W91CRB09D0029 0001	63.6	63.6	295.3	X	X	X	X
	W911SR09D0002 0001	19.3	19.3	321.0	X	X	X	X
	W15P7T10DS229 0002	9.0	9.0	38.6	X	X		X
U.S. Army Program Executive Office for Simulation, Training, and Instrumentation, Florida	W900KK09D0340 0004	6.5	6.5	62.7	X	X	X	X
	W900KK09D0314 0010	8.2	6.9	45.2	X	X	X	X
	W900KK09D0314 0007	8.9	5.7	42.1	X	X	X	X
	W900KK09D0376 0004	10.3	9.2	45.3	X	X	X	X
	W900KK09D0517 0002	2.8	1.9	9.5	X		X	X
	W900KK09D0350 0004	2.8	1.3	16.5	X	X	X	X
	W900KK11C0013	0.9	0.5	2.7	X	X	X	X
	W900KK09D0008 0002	6.5	6.5	36.2	X	X	X	X
Naval Air Station Patuxent River, Maryland	N0001909C0019	5,125.8	1,622.9	12,306.6	X	X	X	X
	N0001909C0052	301.6	163.5	995.0	X	X		X
	N0001910D0006 0001	29.1	29.1	329.0	X	X		X
	N0001910D0006 0002	16.3	16.3	70.8	X	X		X
	N0001909C0086	654.3	409.2	2,870.2	X		X	X
	N0001909C0096	126.7	97.2	1,126.3	X			X
	N0001911C0032	116.7	48.4	176.0	X	X	X	X
	N0042110D0010 0001	20.4	20.4	202.2	X	X	X	X
	N0001911C0022	24.3	17.8	99.3	X		X	X
	N0001910C0069	60.9	53.2	198.6	X	X	X	X
	N0042109C0039	30.7	30.2	277.7	X	X	X	X
	N0001910C0047	92.9	38.3	137.3	X	X	X	X

Appendix B continued

Naval Air Warfare Center, Florida	N6133910C0050	3.6	2.3	13.4	X		X	X
	N6134011C0006	66.5	29.8	138.0	X			X
	N6133910C0038	5.4	1.5	11.9	X	X	X	X
	N6133910C0054	2.0	2.0	21.0	X	X		X
Eglin Air Force Base, Florida	FA867510C0014	471.8	216.5	1,065.9	X	X	X	X
	FA868210C0010	46.7	46.7	709.0	X	X		X
	FA920010C0098	0.7	0.7	3.7	X	X	X	X
	FA867711C0103	0.3	0.2	2.1	X	X	X	X
Hill Air Force Base, Utah	FA821709C0004	2.4	2.4	28.1	X	X		X
	FA822309C0009	9.5	7.5	38.7		X	X	X
	FA823210C0006	2.4	2.4	18.1	X	X	X	X
	FA821709C0011	0.5	0.3	3.8	X	X	X	X
Total		**$13,151.9**	**$7,538.8**	**$28,758.1**	**57**	**44**	**46**	**60**

Appendix C. Select Performance-Based Payment Schedules

The following figures show excerpts from sample contract schedules that include inappropriate events; missing or inadequate success criteria; improper value of events; and the unnecessary use of contract financing. We inserted comment boxes calling out the specific deficiencies for each event excerpt.

Figure C-1. Contract FA8675-10-C-0014

Postaward conference

PBPs	EVENT	PBP DATE	Payment Monthly $	EVENT VERIFICATION
1	Load MRP with Lot 24 Missile quantities	Aug-10	$ 13,067,668	Signed copy of MSIS
2	Conduct PostAward Review (PWAR) at IADC	Sep-10	$ 5,700,857	Copy of PWAR Completion Form
3	Establish WBS Budgets	Oct-10	$ 5,025,456	Certificate of Completion
4	Conduct Post Award Review (PWAR) at ATK	Nov-10	$ 5,096,297	Copy of PWAR Completion Form
5	ATK order Hybrid AFDs	Dec-10	$ 5,637,733	Copy of ATK Purchase Order to supplier
6	ATK order IWR Rocket Motor Forgings	Jan-11	$ 6,599,143	Copy of ATK Purchase Order to forgin supplier
7	Conduct Post Award Review (PAR) at COBHAM	Feb-11	$ 7,228,899	Copy of PAR Completion Form
8	Conduct Post Award Review (PAR) at RSL	Mar-11	$ 8,004,003	Copy of PAR Completion Form
9	Conduct Post Award Review (PAR) at MIDCON	Apr-11	$ 7,225,629	Copy of PAR Completion Form
10	Conduct Post Award Review (PAR) at FCI	May-11	$ 7,564,720	Copy of PAR Completion Form
11	Receipt of Titanium at GD OTS	Jun-11	$ 11,343,307	Copy of receipt from GD OTS
12	Receipt of Rocket Motor Forgings at ATK	Jul-11	$ 13,232,605	Copy of receipt from ATK
13	Conduct Post Award Review (PAR) at L3-IEC	Aug-11	$ 15,371,657	Copy of PAR Completion Form
14	Conduct Post Award Review (PAR) at AIS	Sep-11	$ 17,357,847	Copy of PAR Completion Form
15	Conduct Post Award Review (PAR) at GD-OTS	Oct-11	$ 20,352,458	Copy of PAR Completion Form
16	Conduct Post Award Review (PAR) at Eagle Picher	Nov-11	$ 21,423,274	Copy of PAR Completion Form
17	Conduct Post Award Review (PAR) at Kaman	Dec-11	$ 22,463,053	Copy of PAR Completion Form
18	Receipt of 25th SFM set module at Ball	Jan-12	$ 24,962,370	Copy of receipt from Ball
19	Receipt of 40th Control Section	Feb-12	$ 26,557,778	Copy of PRISM 1010E Replacement Report (See Note A)
20	Receipt of 40th Rocket Motor	Mar-12	$ 26,667,083	Copy of PRISM 1010E Replacement Report (See Note A)
21	Receipt of 50th SFM set module at Ball	Apr-12	$ 28,171,700	Copy of Receipt from Ball
22	Completion of 75th FMS C7 Guidance Section	May-12	$ 27,492,393	Copy of PRISM 1010E Replacement Report (See Note A)
23	Receipt of 25th CALNS IMU	Jun-12	$ 27,053,408	Copy of Outside Receiving Report (ORR)
24	Completion of 25th NDI-AIU	Jul-12	$ 24,139,884	Copy of PRISM 1010E Replacement Report (See Note A)
25	Receipt of the 50th ASFA	Aug-12	$ 21,260,879	Copy of PRISM 1010E Replacement Report (See Note A)
26	Completion of 125th FMS C7 Guidance Section	Sep-12	$ 18,034,389	Copy of PRISM 1010E Replacement Report (See Note A)
27	Completion of the 50th D or D CATM (CUM) missile in PRISM	Oct-12	$ 15,094,833	Copy of PRISM 1010E Replacement Report (See Note A)
28	Completion of the 50th NDI-AIU	Nov-12	$ 11,669,793	Copy of PRISM 1010E Replacement Report (See Note A)
29	Completion of 200th FMS C7 Guidance Section	Dec-12	$ 7,894,970	Copy of PRISM 1010E Replacement Report (See Note A)
30	Completion of the 100th D or D CATM (CUM) missile in PRISM	Jan-13	$ 18,670,184	Copy of PRISM 1010E Replacement Report (See Note A)

Purchase order

Monthly events representing a passage of time

Figure C-2. Contract W900KK-09-D-0008-0002

CLIN 0004AC Spares

EVENT	%	Amount
Complete Material Ordering	40%	46,215
Complete Material Delivery	50%	57,770
Final Acceptance DD250	10%	11,554
Total	100%	$115,539

Purchase order

Maximum 90-percent financing without regard for contractor need

Government acceptance

CLIN 0004AD Tech Data

EVENT	%	Amount
Start Tech Data	40%	5,997
Complete Tech Data	50%	7,498
Final Acceptance DD250	10%	1,500
Total	100%	$14,995

Entry event

Maximum 90-percent financing without regard for contractor need

Government acceptance

CLIN 0004AE Transition Support

EVENT	%	Amount
Start Transition Support	40%	17,113
Complete Transition Support	50%	21,390
Final Acceptance DD250	10%	4,278
Total	100%	$42,781

Entry event

Maximum 90-percent financing without regard for contractor need

Government acceptance

Schedule does not contain verifiable success criteria, expected date of completion, or whether the event is severable or cumulative.

Figure C-3. Contract W31P4Q-09-G-0001-0001

INTERIM Performance Based Milestones

M/S No.	Milestones	Part Number	Part Description	Vendor Name	Verification	Percentage	Milestone Price
1	Issue WAR to Andover Plant to begin Production of Awarded Contract Modification				~~Copy of WAR~~	11.56%	$17,807,000.00
2	Critical Design Review	T/S P2259			Summary Memo (System Generated)	1.58%	$2,434,000.00
3	Open Shop Order	11460092	Metal Fab		INSOST Screen for Shop order	1.94%	$2,990,000.00
4	Placed P.O. (Vendor Material)	11455764	BODY	METAL IMPACT CORP	INSOST and IPSR screen for P.O.	1.84%	$2,829,000.00
5	Open Shop Order	014-11455772	Cable		INSOST Screen for Shop order	1.64%	$2,528,500.00
6	Open Shop Order	11481670	CCA		INSOST Screen for Shop order	1.64%	$2,528,500.00
7	Open Shop Order	11455764	CCA		INSOST Screen for Shop order	1.23%	$1,901,300.00
8	Preliminary Design Review	T/S LO1 Source Assy			Summary Memo (System Generated)	1.58%	$2,434,000.00
9	Preliminary Design Review	T/S PAT245			Summary Memo (System Generated)	1.57%	$2,423,500.00
10	Open Shop Order	10250755-013	Metal Fab		INSOST Screen for Shop order	1.33%	$2,050,000.00
11	Placed P.O. (Vendor Material)	11475175	RADIATOR	ROGERS CORPORATION	INSOST and IPSR screen for P.O.	2.59%	$3,997,300.00
12	Open Shop Order	11455765	Metal Fab		INSOST Screen for Shop order	1.33%	$2,046,500.00
13	Open Shop Order	11466398-002	Metal Fab		INSOST Screen for Shop order	1.45%	$2,240,000.00
14	Open Shop Order	11453722-002	Metal Fab		INSOST Screen for Shop order	1.29%	$1,994,200.00
15	Preliminary Design Review	T/S P2254			Summary Memo (System Generated)	1.29%	$1,994,200.00
16	Placed P.O. (Vendor Material)	11455773-002	Core Assy	Pacific Ceramics Inc	INSOST and IPSR screen for P.O.	2.57%	$3,955,400.00
17	Open Shop Order	11456065	Metal Fab		INSOST Screen for Shop order	1.19%	$1,834,700.00
18	Open Shop Order	11456244	Metal Fab		INSOST Screen for Shop order	1.27%	$1,950,000.00
19	Preliminary Design Review	T/S P2258			Summary Memo (System Generated)	1.31%	$2,017,000.00
20	Critical Design Review	T/S PAT24x			Summary Memo (System Generated)	2.43%	$3,749,800.00
		BALANCE OF INTERIM PERFORMANCE BASED MILESTONES				47.36%	$72,985,100.00
					Total PBP	90.00%	$138,690,000.00
							$154,100,000.00

Entry event for 11.56 percent of contract, not likely to be commensurate with value

Purchase order

Maximum 90-percent financing without regard for contractor profit

Defense Pricing Comments

OFFICE OF THE UNDER SECRETARY OF DEFENSE
3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

ACQUISITION, TECHNOLOGY AND LOGISTICS

MAR 21 2013

MEMORANDUM FOR PROGRAM DIRECTOR FOR DOD PAYMENTS AND ACCOUNTING OPERATIONS, OFFICE OF THE INSPECTOR GENERAL

THROUGH: DIRECTOR, ACQUISITION RESOURCES AND ANALYSIS NS 3/21/13

SUBJECT: Response to DoDIG Draft Report on Award and Administration of Performance-Based Payments in DoD Contracts (Project No. D2012-D000DD-0139.000)

As requested, I am providing responses to the general content and recommendations contained in the subject report.

Recommendation A.1: We recommend that the Director, Defense Pricing issue guidance that:

a. Only includes the use of meaningful events and prohibits the use of purchase orders, the passage of time, acceptance of end items, kickoff meetings, postaward conferences, and entry events as acceptable performance events.

b. States that the purpose of performance-based payment financing is not to provide funding solely because the contractor incurred costs. Rather, it should be tied to specific, measurable, appropriate events.

c. Establishes a requirement that DoD contracting personnel request a contractor estimate of expenditures or other independent data to verify the performance-based payment events and amounts before approving the performance-based payment schedule. In addition, the guidance should require contracting personnel to review any expenditure profile data obtained.

d. Directs DoD contracting personnel to review open performance-based payment contracts with significant event values remaining to determine whether the performance-based payment amounts fairly represent event values. If the amounts do not represent the event value, contracting personnel should consult their legal advisors to assess available corrective actions, including renegotiation of the performance-based payment amounts to comply with Federal Acquisition Regulation requirements.

Response: Concur. The Director, Defense Pricing will issue guidance addressing the topics contained in the recommendation.

Recommendation A.2: Develop a performance-based training program that includes a discussion of appropriate performance-based payment events and require all DoD contracting

personnel involved in the negotiation and award of performance-based payments to participate in the program. The training should specifically prohibit purchase orders, kickoff meetings, postaward conferences, entry events, passage of time, or the acceptance of end items as events.

Response: Concur. The Defense Acquisition University recently deployed a four hour continuous learning module on performance based payments and the value of cash flow. In order to ensure training is provided to all contracting personnel involved in the award, negotiation and administration of performance-based payments, the Director, Defense Pricing will direct contracting personnel to complete this continuous learning module as part of their continuous learning requirement effective fiscal year 2014.

Additionally, the Defense Acquisition University has developed an eight hour lesson on Performance Based Payments which reinforces the information in the continuous learning module and includes a two part workshop which addresses the specifically cited topics. This lesson segment currently is part of a required course for Level II certification under the Defense Acquisition Workforce Improvement Act. Effective fiscal year 2014, this lesson will be a required course for Level 1 certification so contracting personnel receive this training very early in their appointment to contracting.

Recommendation B.1: We recommend that the Director, Defense Pricing update 2012 draft guidance that:

a. Defines how and when a performance-based payment event is successfully completed,
b. Defines what comprises a severable or cumulative event, and
c. Updates the contract financing checklist to ensure the entire required event elements are included in the performance-based payment schedule.

Response: Concur. The Director, Defense Pricing will update the 2012 draft "Performance Based Payments Guide – The Better Buying Power Initiative" to address the issues cited before releasing for final publication.

Recommendation B.2: Develop a performance-based payment contract financing training program that:

a. Includes a discussion on successful completion criteria, severable and cumulative events, and the need for estimated event completion dates tailored to performance levels required for contract completion, and
b. Is required of all DoD contracting personnel involved in the negotiation, award, and administration of performance-based payments.

Response: Concur. See response to Recommendation A.2.

Recommendation C: We recommend that the Director, Defense Pricing issue guidance requiring contracting personnel to:

1. Determine whether the contractor can obtain private financing at a reasonable rate

before allowing PBP financing.

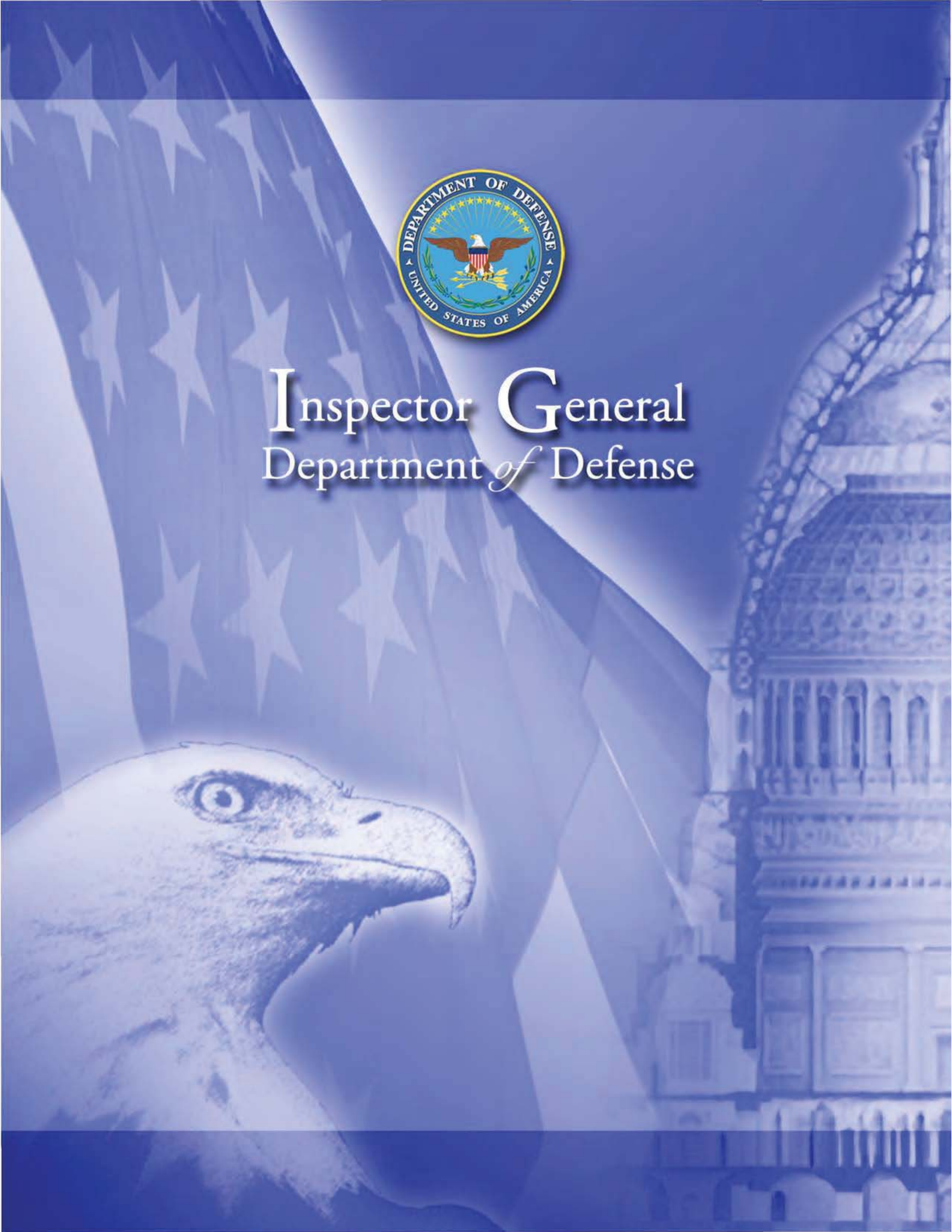
2. Determine an appropriate financing rate. This determination should include guidance on how to use Federal Acquisition Regulation clause 52.232-28 to obtain information on contractor investment and a definition of what a reasonable level of contractor investment is, and an understanding that performance-based payment events should not generally include contractor profit.

3. Refrain from including the Federal Acquisition Regulation clause 52.232-32 at contract inception for sole-source contracts, unless they have sufficient evidence that the contractor needs contractor financing. This will help ensure that DoD receives adequate consideration for contract financing in sole-source acquisitions.

Response: Concur. Defense Pricing will issue guidance addressing the topics contained in the recommendation.

Please contact [redacted] if additional information is required.

Shay Assad
Director, Defense Pricing


Inspector General
Department of Defense